MAR 13 1957
JOHN T. FEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 838

THE GREGG COMPANY OF DELAWARE,
Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

No. .....

October Term, 1956

———o———

The Gregg Company of Delaware,
Petitioner,

against

Commissioner of Internal Revenue,
Respondent.

———o———

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above case on December 17, 1956.

Opinions Below

The opinion of the Tax Court of the United States (p. 3a) is reported at 23 T. C. 170.

The opinion of the Court of Appeals for the Second Circuit is reported at 239 F. 2d 498.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was made and entered on December 17, 1956 (p.

85a) and copies thereof are appended to this petition at pages 11 to 19. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Questions Presented

1. If, as held by the Court of Appeals, the petitioner was a corporation having a business purpose, were the payments made by the petitioner to the holders of its outstanding Fifty Year 4% Income Notes (hereinafter called "Notes") deductible as interest on its indebtedness under Section 23(b) of the *Internal Revenue Code* of 1939.

2. If, on the other hand, as held by the Tax Court, the petitioner was a mere conduit to receive dividends and to distribute those same amounts to the holders of its Notes, can the petitioner be taxed on the amounts received and at the same time be denied deduction for the amounts distributed.

Statutes Involved

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.
>
> * * * * *
>
> (26 U.S.C. 1952 ed., Sec. 23.)

Statement

The petitioner's Fifty Year 4% Income Notes were issued in 1933 pursuant to the plan of reorganization of the Gregg Company Ltd., a New York corporation (hereinafter called the "New York Company"). The entire issue of such Notes was distributed pro rata, pursuant to the plan of reorganization, to the common stockholders of the New York Company. There has never been any question but that all exchanges made pursuant to such plan of reorganization were non-taxable and that such distribution of the Notes was non-taxable.

The New York Company was organized in 1903 and was engaged in the business of manufacturing railway cars and equipment in the United States and selling such cars and equipment throughout the world, especially in Latin America (pp. 4a-5a, 14a). During the period from 1929 to 1932 all the manufacturing operations were transferred to its wholly owned subsidiary, Societe Gregg d'Europe, a Belgian corporation organized in 1927 (hereinafter called the "Belgian Company") (pp. 5a, 14a-15a). The New York Company, however, continued to conduct all the selling operations and to own all patents and inventions, inventories, work in progress and finished products at the plant of the Belgian Company (pp. 5a, 77a-78a).

In 1933, when it developed that all the customers of the enterprise were outside of the United States and that all of the manufacturing was conducted outside the United States, the management decided that substantial economics, greater efficiency in operations and savings in taxes would be effected by organizing a foreign corporation to carry on the business of the New York Company (pp. 5a, 79a).

Pursuant to advice of counsel, The Gregg Company of Delaware (sometimes hereinafter called the "Delaware

Company"), the petitioner herein, was organized on October 18, 1933. On October 31, 1933, the New York Company transferred substantially all of its assets (which included all of its foreign assets) to the Delaware Company in exchange for the entire authorized Capital Stock of the Delaware Company consisting of 2,000 shares of Capital Stock without par value and $1,000,000 face amount of the 4% Income Notes maturing February 1, 1984. Immediately thereafter, the New York Company distributed the Income Notes to its stockholders in the same proportions in which they held common stock in the New York Company. The assets so acquired by the Delaware Company from the New York Company had an actual value of at least $1,318,000 (pp. 5a-6a, 18a-19a; Exhibits 21U, p. 42a, 23W, p. 53a, 35II, p. 72a).

On November 1, 1933, the petitioner sold to Gregg Car Company, Ltd., a corporation organized on October 24, 1933, under the laws of the Republic of Panama (hereinafter called the "Panama Company"), substantially all of its assets having an actual value of at least $1,316,000 in exchange for the entire authorized issue of the 4% Preferred Stock of the Panama Company having an aggregate par value of $1,000,000 (pp. 6a, 18a-20a, 79a; Exhibits 28BB, p. 59a, 31EE, p. 60a, 32FF, p. 61a). During all of the tax years under consideration here, the sole function of the petitioner was to hold the 4% Preferred Stock of the Panama Company, the income from which flowed to the noteholders. In 1939 approximately 32% of the outstanding 4% Preferred Stock of the Panama Company was redeemed and at the same time an equal amount of the Notes of the petitioner was redeemed (pp. 8a, 82a-83a).

The outstanding Notes of the petitioner mature on February 1, 1984. By their terms the Notes provide for an interest rate not exceeding 4% per annum payable out of

the surplus net earnings and income for the preceding calendar year but only if and to the extent that the surplus net earnings and income of the Company shall suffice for such payment (pp. 6a-7a; Para. 1, Exhibit 25Y, p. 54a). In order to determine surplus net earnings and income, there are deductible from gross earnings for the interest period, current business expenses, taxes, insurance charges, interest on obligations other than these Notes, and reserves set aside for any proper purpose or contingency. Once the interest is earned it becomes a debt (p. 7a; Para. 3, Exhibit 25Y, p. 55a). The Notes are callable by the issuer at any time at their face amount plus interest for the current year plus earned but unpaid interest for prior years. In the event of liquidation, dissolution or insolvency, the Notes become due and payable immediately (pp. 7a-8a; Paras. 5 and 6, Exhibit 25Y, pp. 56a-57a). The Noteholders have no voting rights and no voice in the management (p. 8a; Exhibit 25Y, p. 54a). At the time the Notes were issued it was anticipated that they would ultimately become widely distributed. One of the important reasons for the issuance of Notes instead of stock was to retain management and control in the hands of the original owners (pp. 9a, 81a).

During the calendar years 1935 through 1944 and 1947 through 1949, inclusive, the petitioner paid interest at the rate of 4% to the holders of its outstanding Fifty Year 4% Income Notes. The petitioner deducted such payments in its returns for the years in which paid. The Commissioner denied the deductions and the Tax Court sustained the Commissioner. The Court of Appeals affirmed.

After examining in some detail the income provisions of the petitioner's Notes, and particularly the provisions with respect to reserves for contingencies, no need for which ever arose, the court found the petitioner's Notes to be "hybrid securities" and said that since we are

> "* * * confronted with 'hybrid' securities, issued by the alleged debtor contemporaneously with its creation, it is necessary to consider the individual provisions of the Income Notes and the history of their issuance and subsequent treatment in order to determine whether they represent an actual indebtedness or, in reality, equity capital."

At another point the court said:

> "* * * When such 'hybrid' securities are involved, the problem of characterization is one of considering each case on all of its facts. See *John Kelley Co.* v. *Commissioner* (*Talbot Mills* v. *Commissioner*), 326 U. S. 521 (1946)."

The court regarded as particularly significant in the context of "hybrid securities" the provisions of the Notes relating to the payment of interest and emphasized the following:

1) "No fixed rate of interest is provided; in fact there is not even a minimum rate of interest, but only a maximum of 4% per year.

2) "Even this indeterminate amount is to be paid only if there be surplus net earnings and income for the preceding year. In determining that surplus, the directors may deduct, in addition to all expenses incurred in the conduct of the business, such sums as they 'in their absolute discretion set aside as a reserve for any proper purpose or contingency.'

3) "Furthermore, the interest is non-cumulative in the event it is not earned in any given year...

4) "If there should be amounts available for payment as interest even then payment can be withheld if the directors believe that the net quick asset position of

> the Company makes it 'undesirable to make such payment.' Very significantly, any earned amounts thus withheld are to be paid out at the discretion of the board of directors, but without interest for the time during which payment is withheld."

On the basis of "the provisions of the Income Notes and the history of their issuance and subsequent treatment", the court agreed with the conclusion of the Tax Court that the Notes were not "evidences of indebtedness" and that "the 'interest' payments were in reality dividends," thus affirming the Tax Court's denial of the deductions claimed for interest paid.

The same court's decision in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (2d Cir. 1956), which will be referred to below, was distinguished from the petitioner's case as follows:

> "In support of this appeal, the petitioner relies heavily on the recent decision by this court in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (2d Cir. 1956). But that case is clearly distinguishable from the one at bar for there 'the debentures were simple in form and contained an unconditional promise to pay the principal amount' with interest at a fixed rate (6%) per annum. *Kraft Foods Co.* v. *Commissioner, supra*, at 121. There the parties 'objectively manifested their intent' to create a creditor-debtor relationship between two pre-existing 'going concerns' by the clear language of the debentures themselves."

Reasons Why the Writ Should Be Granted

The underlying question in the case at bar is that of "thin" or "inadequate capitalization", raised for the first

time by the dictum of this Court in *John Kelley Company* v. *Commissioner* and *Talbot Mills* v. *Commissioner*, 326 U. S. 521 (1946). The point has never been passed upon by this Court although it has been before the lower courts in numerous cases.[1] The literature published in the ten years since the utterance of that dictum shows the question to be one of general interest and concern under the Internal Revenue Code.[2] Stated another way the question is simply this: Is it within the province of the Commissioner to deny deduction for interest paid on the debt of a corpo-

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1. *Bachrach* v. *Commissioner*, 18 T. C. 479 (1952), affd. per curiam 205 F. 2d 151; *Bair et al.* v. *Commissioner*, 16 T. C. 90, affd. 199 F. 2d 589 (2nd Cir., 1952); *Cleveland Adolph Mayer Realty Corp.* v. *Commissioner*, 6 T. C. 730, reversed on other grounds 160 F. 2d 1012; *Colony Inc.*, 26 T. C. 30; *Isidor Dobkin* v. *Commissioner*, 15 T. C. 31 (1950), affd. per curiam 192 F. 2d 392; *Estate of Herbert B. Miller*, 24 T. C. 923 (1955), reversed .... F. 2d .... (C. A. 9th, December 27, 1956); *Gooding Amusement Co., Inc.*, 236 F. 2d 159 (C. A. 6th, 1956); *R. M. Gunn*, 25 T. C. #54 (1955); *Kraft Foods Company* v. *Commissioner*, 232 F. 2d 118 (C. A. 2d, 1956); *Matthiessen et al.* v. *Commissioner*, 194 F. 2d 659 (C. A. 2d, 1952; *Mullin Building Corp.* v. *Commissioner*, 9 T. C. 350 (1947), affd. per curiam 167 F. 2d 1001; *Root* v. *Commissioner*, 220 F. 2d 240 (C. A. 9th, 1955); *Rowan* v. *U. S.*, 219 F. 2d 51 (C. A. 5th, 1955); *Ruspyn Corp.* v. *Commissioner*, 18 T. C. 769 (1952); *Chas. Schaefer & Son, Inc.* v. *Commissioner*, 9 T. C. M. 1035 (1950); *Sun Properties, Inc.* v. *U. S.*, 220 F. 2d 171 (C. A. 5th, 1955); *Swoby Corp.* v. *Commissioner*, 9 T. C. 887 (1947); *John Walter, Inc.*, 23 T. C. 550 (1954).

2. Note, *Thin Capitalization and Tax Avoidance*, 55 Colum. L. Rev. 1054 (1955); *Kramer, Tax Consequences of Inadequate Equity Capital: The Thin Incorporation Problem*, 96 Journ. of Accountancy 449 (1953); 4 *Merten's Law of Federal Income Taxation*, Section 26.10c; 2 *Rabkin & Johnson, Federal Income, Gift and Estate Taxation*, Section 37.10(8); *Semmel*, 5 Tax Law Review 424 (March 1950); *Stanford, What is Adequate Capitalization?*, 31 Taxes 231 (1953).

ration, on the ground that, in his judgment, the debt-equity ratio is disproportionate?

No case involving this area of the tax law can be disposed of without consideration of *Kraft Foods Company* v. *Commissioner, supra.* The *Kraft* case, which reversed a decision concurred in by fourteen of the sixteen Judges of the Tax Court (21 T. C. 513), seems to have established the rule that, at least in the absence of a disproportionate debt-equity ratio, interest on the obligations of a corporation is deductible even though (1) the instruments were issued to and continued to be held by the sole stockholder, (2) no new capital was paid in, and (3) the debt was created avowedly for the sole purpose of tax avoidance and had no other business purpose, where the parties, by the form of the instrument, objectively manifested their intention to create a debt. If this decision is regarded as authority for the proposition that, absent the factor of so-called thin capital, the intention of the issuer to create a debt, the interest on which is deductible, may be determined entirely by the form of the instrument, the decision is in direct conflict with *Kelley* v. *Commissioner, supra.*

The Notes in the case at bar and the notes in the *Kelley* case, contained substantially the same provisions and in both cases the instruments were "income notes". That is to say, the interest accrued and became payable only if earned. The interest paid on the notes in the *Kelley* case was allowed by the Tax Court and that decision was sustained by this Court. Under the test applied by the Second Circuit in the *Kraft* case, deduction for the interest paid in the *Kelley* case would be denied.

In the case at bar, however, the Court of Appeals distinguished the *Kraft* case on the ground that here the Notes were "hybrid securities", and represented equity capital, principally for the reason that the Notes were income notes (like those in the *Kelley* case), the interest

on which was payable only out of earnings. This raises the question as to whether, in any case, interest on a binding obligation, in form an income note, is deductible for tax purposes.

From the standpoint of the form of the securities, it is difficult, in retrospect, to distinguish between *John Kelley Company* v. *Commissioner* and the companion case, *Talbot Mills* v. *Commissioner*, *supra*. The Tax Court, in the *Talbot Mills* case, seems to have been influenced strongly by the factor of tax avoidance but, as stated above, this point was expressly negatived by the Court of Appeals in the *Kraft* case.

Despite the fact that thin capitalization was not discussed either by the Tax Court or by the Court of Appeals in the instant case, an examination of their opinions will disclose at once that this concept was the moving factor in the disallowance of the interest deduction. The case at bar is a clear-cut illustration of a recurring problem which, in general, the courts below have not faced up to.

Simply stated, the thin capitalization question raised in the instant case is this: Has the Commissioner the authority to deny deduction for interest paid by a corporation on its debt where the corporation is engaged in business as a holding company, on the ground that, for the taxable year under consideration, payment of such interest absorbed the entire gross income, thus leaving nothing available for payment of dividends to its stockholders?

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

KENNETH W. MORONEY,
Counsel for Petitioner.

Opinion

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

———o———

No. 2—October Term, 1956.

(Argued November 7, 1956 Decided December 17, 1956.)

Docket No. 23621

———o———

THE GREGG COMPANY OF DELAWARE,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

———o———

Before:

MEDINA, LUMBARD and WATERMAN,

Circuit Judges.

———o———

Petition for review of a decision of the Tax Court, 1954, 23 T. C. 170, denying petitioner any deduction under 26 U. S. C. A. (I. R. C. 1939) §23(b) for payments of alleged interest on petitioner's "Fifty-Year 4% Income Notes." Affirmed.

———o———

KENNETH W. MORONEY, New York City, *for Petitioner*.

CHARLES K. RICE, Assistant Attorney General, Lee A. Jackson, Harry Baum, Henry Kutz, Attorneys, Department of Justice, Washington, D. C., *for Respondent*.

———o———

WATERMAN, *Circuit Judge*:

The petitioner, The Gregg Company of Delaware, appeals from a decision of the Tax Court, 23 T. C. 170 (1954) that the amounts paid by petitioner to its parent corporation on its so-called "Fifty-Year 4% Income Notes" were not deductible "interest * * * on indebtedness" within the meaning of Section 23(b) of the Revenue Act of 1934, 1936, and 1938, 26 U. S. C. A. (I. R. C. 1939) §23(b). Petitioner asserts that these Notes were evidence of a valid indebtedness and therefore it was entitled to a tax deduction for the payment of interest thereon.

We believe the Tax Court was so clearly correct in its disposition of this case that we would affirm on the opinion of Judge Murdock, 23 T. C. 170, were it not that subsequent to his opinion we decided an appeal from that court in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (2 Cir. 1956), and the petitioner here relies upon our opinion in that case to support its contention that the Tax Court erred.

The involved facts in the present appeal are set forth in detail in the Tax Court opinion. Many of these facts were stipulated by taxpayer and Commissioner. The Fifty-Year 4% Income Notes, as will hereinafter appear, have some of the characteristics of a conventional debt issue and some of the characteristics of a conventional equity issue. When such "hybrid" securities are involved, the problem of characterization is one of considering each case on all of its facts. See *John Kelley Co.* v. *Commissioner* (*Talbot Mills* v. *Commissioner*), 326 U. S. 521 (1946). Therefore, despite the detailed statement of facts in the Tax Court opinion, we must summarize the history behind the issuance of the taxpayer's Fifty-Year 4% Income Notes; and, in the light of that history, examine the nature of the transaction evidenced by them in order to

realistically understand the meaning and purpose of the actual provisions contained therein.

Taxpayer is a Delaware corporation, incorporated in 1933. Prior to its incorporation the Gregg family had been actively engaged in the business of building and selling railway cars and equipment in various parts of the world, primarily in Latin America. In 1903 the Gregg Company, Ltd., a New York corporation, hereinafter called "New York," was organized as the original corporate entity engaged in this business. During the period from 1929 to 1932 all the manufacturing operations of New York were transferred to a wholly-owned subsidiary, Societé Gregg d'Europe, a Belgian corporation, organized in 1927. New York, however, continued to conduct all the selling operations; to own the patents and inventions, the inventories, work in process, and finished goods; and to exercise entire control over the merchandise and the operations of the Belgian corporation. In 1933, since all of the business of the enterprise, as well as the manufacturing, was conducted outside the United States, it was decided to organize a foreign corporation to carry on the operations of New York. The Tax Court found that this was done to avoid United States income taxes assessed against New York upon profits made elsewhere. The taxpayer, The Gregg Company of Delaware, petitioner here, was organized on October 18, 1933 as the first step in the execution of this intention. On October 31, 1933, New York transferred substantially all of its assets, including its foreign assets, to taxpayer in exchange for taxpayer's entire authorized capital stock consisting of 2,000 shares of capital stock without par value and for $1,000,000 face value of taxpayer's Fifty-Year 4% Income Notes. Thereupon, New York distributed these Income Notes to the stockholders of New York in the same proportions in which they held New York common stock. The assets so acquired by tax-

payer from New York had an actual value of at least $1,318,000, New York retaining some assets of an undisclosed value. After taxpayer was organized, and before the transaction with New York of October 31, 1933, a corporation was organized on October 24, 1933 under the laws of the Republic of Panama. On November 1, 1933, the day after the transaction between New York and taxpayer, taxpayer transferred to the Panama corporation, Gregg Car Company, Ltd., all of the assets so acquired from New York, except $2,000 in cash, being assets having an actual value of at least $1,316,000,—and received in exchange therefor the entire authorized issue of 4% non-cumulative voting preferred stock of the Panama corporation, having an aggregate par value of $1,000,000. Therefore, if all went well, taxpayer would receive income of $40,000 annually by its receipt of dividends from Panama, and would pay out $40,000 annually to the stockholders of New York by the payment proportionately to each of them each year of a 4% return on $1,000,000.

The "Fifty-Year 4% Income Notes" issued by taxpayer were to mature February 1, 1984. They bore interest from January 1, 1934, at a rate not to exceed 4%, payable on February 1 of each succeeding year. The interest was payable "out of the surplus net earnings and income for the preceding calendar year but only if and to the extent that the surplus net earnings and income of the Company shall suffice for such payment; such interest shall not be cumulative and no part of the interest hereon for the payment of which the surplus net earnings and income for any interest year shall be insufficient shall be a charge upon or shall be paid from the income of any other year." Current expenses of the business, taxes, insurance charges, other interest charges, and such sums as the board of directors in their discretion might set aside as a reserve for any purpose or contingency were to be deducted from the gross

earnings for the interest period in determining the surplus net earnings applicable to the payment of interest. The amounts available up to 4% were to be paid promptly "unless in the judgment of the Board of Directors, the net quick asset position of the Company shall render it undesirable to make such payment," but any earned interest thus withheld was to accumulate and be payable without interest when the board might determine, or at maturity if not paid prior thereto. The determination of the board of directors as to the surplus net earnings applicable to the payment of interest was to be final and conclusive. The Notes were subject to redemption in whole or in part at any time prior to maturity upon ten days notice. They were to become due and payable immediately in the event of liquidation or insolvency of the company. They were also transferable. They contained no provisions subordinating payment of principal to claims of general creditors, they were not secured, and they had no voting privileges.

Panama paid the petitioner $40,000 in 1935 as the first dividend on the preferred stock and made like payments in each year through 1939. The petitioner paid out all of that amount, as received, to the holders of its "Income Notes." In 1939 $319,100 par value of the petitioner's "Income Notes" was retired at par for cash and, significantly, Panama retired an equal amount of its preferred stock. The occasion was the sale by Louis D. Gregg and members of his family of all their interests in the Gregg companies. Therefore, after for each of the years 1940 through 1949, except 1945 and 1946, Panama paid to the petitioner $27,236 as dividends on preferred stock. It made no payments for the years 1945 and 1946. The petitioner for each of the years 1940 through 1944 paid to the holders of its Income Notes $27,233.76; made no payment in 1945 and 1946, and paid to Income Noteholders $27,233.77 for the years 1947 through 1949.

In support of this appeal, the petitioner relies heavily on the recent decision by this court in *Kraft Foods Co.* v. *Commissioner,* 232 F. 2d 118 (2d Cir. 1956). But that case is clearly distinguishable from the one at bar for there "the debentures were simple in form and contained an unconditional promise to pay the principal amount" with interest at a fixed rate (6%) per annum. *Kraft Foods Co.* v. *Commissioner, supra,* at 121. There the parties "objectively manifested their intent" to create a creditor-debtor relationship between two pre-existing "going concerns" by the clear language of the debentures themselves.

Here, however, since we are confronted with "hybrid" securities, issued by the alleged debtor contemporaneously with its creation, it is necessary to consider the individual provisions of the Income Notes and the history of their issuance and subsequent treatment in order to determine whether they represent an actual indebtedness or, in reality, equity capital. See Mertens, Law Of Federal Income Taxation §26.10. Cf., e.g., *Jordan Co.* v. *Allen,* 85 F. Supp. 437, 443-45 (M. D. Ga. 1949).

Particularly significant in this context are the provisions of the Income Notes relating to the payment of interest. No fixed rate of interest is provided; in fact, there is not even a minimum rate of interest, but only a maximum of 4% per year. Even this indeterminate amount is to be paid only if there be surplus net earnings and income for the preceding year. In determining that surplus, the directors may deduct, in addition to all expenses incurred in the conduct of the business, such sums as they "in their absolute discretion set aside as a reserve for any proper purpose or contingency." Furthermore, the interest is non-earned cumulative in the event it is not ~~paid~~ in any given year. As stated above, no interest at all was paid in 1945 or 1946. If there should be amounts available for payment as inter-

est even then payment can be withheld if the directors believe that the net quick asset position of the Company makes it "undesirable to make such payment." Very significantly, any earned amounts thus withheld are to be paid out at the discretion of the board of directors, but without interest for the time during which payment is withheld. ~~Since the Income Notes obviously differ from customary instruments evidencing true long-term debts, and have an unmistakable similarity to dividend-bearing instruments, the Tax Court properly considered the circumstances surrounding their original issuance.~~ The facts found by the Tax Court clearly demonstrate that the petitioner was formed in 1933 as an integral part of an overall plan whereby United States corporate income taxes on profits earned outside the country by the Gregg activities were to be eliminated. In addition, taxation of the petitioner also was to be avoided by offsetting its earnings with an equal amount of "interest" payments to the noteholders.

The Notes were not issued for new capital obtained by the Greggs from outside sources, nor for borrowed money. They were issued in exchange for the assets of New York, which, like the petitioner, was a Gregg family corporation. Since the Notes were distributed to the shareholders of New York in proportion to their equity interests in that company, the relative interests in the Gregg businesses of each New York stockholder was not changed. In 1939, when the taxpayer's Notes held by Louis Gregg and his family were retired, the Panama company also retired an equal amount of its preferred stock, thus illustrating the correlation between the taxpayer's Income Notes and the equity interests in the Gregg enterprises.

The provisions of the Income Notes and the history of their issuance and subsequent treatment clearly support the Tax Court conclusion that they were never evidences of indebtedness, but actually represented disguised equity

capital. The "interest" payments were in reality dividends, and hence the petitioner is not entitled to any deductions therefor under Section 23(b).

II

Petitioner, as an alternative ground for reversal, claims that since the Tax Court characterized it as a "mere conduit to receive dividends," it was not engaged in any business activity and therefore should not be regarded as a taxable entity under the rule of *Moline Properties, Inc.* v. *Commissioner,* 319 U. S. 436 (1943). This contention, which was not even urged in the proceedings below, can be disposed of readily. The petitioner was originally formed in order to effectuate a tax-free reorganization, the purpose of which was found by the Tax Court to be the elimination of a corporate tax on the foreign profits of the Gregg operations. The reorganization was accomplished, and the petitioner served continuously as a holding company from that date forward, reporting as its corporate income the dividends it received from the corporate stock it held. Thus the petitioner has performed the functions for which it was created, and those functions are sufficient to constitute a "business activity" for purposes of taxation. See *National Investors Corp.* v. *Hoey,* 114 F. 2d 466, 468 (2d Cir. 1944).

Order affirmed.

Judgment

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 17th day of December one thousand nine hundred and fifty-six.

Present: HON. HAROLD R. MEDINA,
HON. J. EDWARD LUMBARD,
HON. STERRY R. WATERMAN,
Circuit Judges

THE GREGG COMPANY OF DELAWARE
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent

APPEAL FROM THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

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IN THE

Supreme Court of the United States

October Term, 1956

No. 838

THE GREGG COMPANY OF DELAWARE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3a-12a)[1] are reported at 23 T. C. 170. The opinion of the Court of Appeals (Pet. 11-18) is reported at 239 F. 2d 498.

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[1] Record references are to the appendix to the petitioner's brief filed in the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals (Pet. 19) was entered on December 17, 1956. The petition for a writ of certiorari was filed on March 15, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion, affirmed by the court below, that so-called interest on "Income Notes"—hybrid securities possessing the characteristics of both conventional debt and conventional equity issues—paid by the taxpayer corporation to the stockholders of its parent corporation, constituted nondeductible dividend distributions, and not deductible interest on indebtedness.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

* * * *

(26 U. S. C. 1952 ed., Sec. 23(b).)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a

> corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.
>
> * * * *
>
> (26 U. S. C. 1952 ed., Sec. 115(a).)

The provisions of Sections 23(b) and 115(a) of the Revenue Acts of 1934, c. 277, 48 Stat. 680; 1936, c. 690, 49 Stat. 1648; and 1938, c. 289, 52 Stat. 447, are substantially the same.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> Sec. 29.23(b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.
>
> * * * *
>
> * * * So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

The provisions of Article 23(b)-1 of Treasury Regulations 86, 94, and 101, promulgated under the Revenue Acts of 1934, 1936, and 1938, respectively, and of Section 19.23(b)-1 of Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939, are the same.

STATEMENT

The facts, as found by the Tax Court (R. 3a-12a) and summarized by the Court of Appeals (Pet. 13-17), are as follows:

The Gregg Company, Ltd., a New York corporation (hereinafter called New York, or the parent), was until 1933 engaged in the business of manufacturing and selling railway cars and equipment in various parts of the world. All but 630 of its 18,903 outstanding shares of $100 par value stock were owned by members of the Gregg family. (R. 4a-5a.) New York owned all of the outstanding stock (except qualified shares) of Societe Gregg d'Europe, a Belgian manufacturing corporation (hereafter called Belgian). It also financed and controlled Belgian's operations, and sold its products. (R. 5a; Pet. 13.)

In 1933 the common stockholders of New York (i.e., the Gregg family), after consulting accountants and attorneys, devised a plan for avoiding United States corporation income taxes on foreign profits by means of a transfer of New York's foreign operating assets to a foreign corporation, but without subjecting New York or its stockholders to tax liability on the transfer under Section 112(k) of the Revenue Act of 1932.[2] Pursuant to the plan, the Gregg Com-

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[2] Section 112(k) of the Revenue Act of 1932, c. 209, 47 Stat. 169, provided:

> (k) *Foreign Corporations.*—In determining the extent to which gain shall be recognized in the case of any of the exchanges or distributions (made after the date of the enactment of this Act) described in subsection (b)(3), (4), or (5), or described in so much of subsection (c) as refers to subsection (b)(3) or (5), or described in subsection (d) or (g), a foreign corporation shall not be considered as a corporation unless, prior to such exchange or distribution, it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a

pany of Delaware (hereafter called the taxpayer) was organized under the laws of Delaware, and the assets of New York relating to its foreign operations were transferred to the taxpayer on October 31, 1933, in exchange for all of taxpayer's 2,000 shares of no par value common stock and $1,000,000 face amount of taxpayer's "Fifty-Year 4% Income Notes." The notes were immediately distributed by New York pro rata to its stockholders, and the par value of New York's common stock was reduced from $100 to $5 per share, an amount approximating the book value of the transferred assets. A new corporation (hereafter called Panama) was also organized under the laws of Panama, and all but $2,000 of the assets which the taxpayer received from New York were on the same day (October 31, 1933) transferred by the taxpayer to Panama in exchange for $1,000,000 par value four per cent noncumulative voting preferred stock of Panama. The common stock of Panama was subscribed for by New York's common stockholders on a share for share basis at ten cents per share, or a total of $1,890.30 for 18,903 shares. Panama then took over the operation of the foreign business, using Belgian as the manufacturing corporation. (R. 5a-6a, 10a-12a, 22a-24a; Pet. 13-14.)

The "Fifty-Year 4% Income Notes" issued by the taxpayer were to mature February 1, 1984. They bore interest from January 1, 1934, at a rate not to

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plan having as one of its principal purposes the avoidance of Federal income taxes.

Section 112(i) of the Revenue Acts of 1934, 1936 and 1938, *supra*, and of the Internal Revenue Code, is substantially the same.

exceed four per cent payable on February 1 of each succeeding year. The interest was payable "out of the surplus net earnings and income for the preceding calendar year but only if and to the extent that the surplus net earnings and income of the Company shall suffice for such payment; such interest shall not be cumulative and no part of the interest hereon for the payment of which the surplus net earnings and income for any interest year shall be insufficient shall be a charge upon or shall be paid from the income of any other year." Current expenses of the business, taxes, insurance charges, other interest charges, and such sums as the board of directors in their discretion might set aside as a reserve for any proper purpose or contingency were to be deducted from the gross earnings for the interest period in determining the surplus net earnings applicable to the payment of interest. The amounts available up to four per cent were to be paid promptly "unless in the judgment of the Board of Directors, the net quick asset position of the Company shall render it undesirable to make such payment," but any earned interest thus withheld was to accumulate and be payable without interest when the board might determine or at maturity if not paid prior thereto. The determination of the board of directors as to the surplus net earnings applicable to the payment of interest was to be final and conclusive. The notes were subject to redemption in whole or in part at any time prior to maturity upon ten days' notice, were to become due and payable immediately in the event of liquidation or insolvency of the company, and were trans-

ferable. They contained no provision subordinating payment of principal to claims of general creditors, were not secured, and had no voting privileges. (R. 6a-8a, 54a-58a; Pet. 14-15.)

Panama paid to the taxpayer $40,000 in each year from 1935 through 1939, as dividends on the preferred stock. The taxpayer paid out all of this money, as received, to the holders of its notes, as interest on the notes. In 1939 Panama redeemed $319,000 of its preferred stock, and the taxpayer in turn redeemed an equal amount of its notes. Thereafter, for each of the years 1940 through 1949, except 1945 and 1946, Panama paid to the taxpayer $27,236 as dividends on the remaining preferred stock, and for each of the same years the taxpayer paid to the holders of its notes substantially the same amount ($27,233.76) as interest. (R. 8a, 71a; Pet. 15.)

At the hearing, William B. Gregg, the only witness called for the purpose, testified that the taxpayer issued notes instead of preferred stock because members of the Gregg family expected to bequeath the notes to other members of the family whom they did not wish to have voting rights, and because notes having a maturity date would have more value than preferred stock. (R. 8a-9a, 81a.)

There was never any intention that the taxpayer would engage in conventional business operations. It was intended that Panama would take over from New York the operation of the foreign business, and that taxpayer would own Panama's preferred stock. The taxpayer, in this sense, was a mere conduit to receive dividends on the preferred stock of Panama,

which it was allowed to own, and to distribute those same amounts to the holders of its income notes. It had no other source of income and no means of paying the principal of the notes except from the retirement of the preferred stock of Panama. Taxpayer was originally formed in order to effectuate a tax-free reorganization, the purpose of which was the elimination of a corporate tax on the foreign profits of the Gregg operations; the reorganization was accomplished, and the taxpayer served continuously as a holding company from that date forward, reporting as its corporate income the dividends it received from the corporate stock it held. (R. 6a, 10a-11a; Pet. 18.)

In its income and excess profits tax returns for the taxable years (1935 through 1944, and 1947 through 1949), the taxpayer reported as income the dividends received as holder of Panama's preferred stock, and deducted like amounts as interest paid to the holders of its "Fifty-Year 4% Income Notes." The Commissioner disallowed the claimed deductions and determined deficiencies accordingly.[3] (R. 4a.) The Tax Court sustained the Commissioner's determination. The Court of Appeals affirmed. (R. 9a-12a; Pet. 19.)

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[3] For each year (except 1949) the Commissioner also added a penalty for failure to file a timely return, as prescribed in Section 291(a) of the Internal Revenue Code of 1939 and corresponding provisions of prior Revenue Acts. The taxpayer conceded below that if the deficiency determinations were correct, then the additions to the deficiencies were also correct. (R. 4a.)

ARGUMENT

1. In affirming the Tax Court's determination that the payments which the taxpayer made to the stockholders of its parent corporation on the income notes in question were dividend distributions, and not deductible interest payments, the decision below correctly applies the principles established by this Court in *John Kelley Co.* v. *Commissioner* (decided with *Talbot Mills* v. *Commissioner*), 326 U. S. 521. There it was held that whether a corporate payment constitutes deductible interest or a nondeductible dividend distribution presents a question of ultimate fact in each case, depending upon whether the true relationship of the parties is that of debtor-creditor or corporation-stockholder. In determining that relationship, this Court held that consideration should be given to (*Kelley* case, pp. 526, 530) "the characteristics of * * * the obligations in question and the surrounding circumstances," and it warned that "no one characteristic * * * can be said to be decisive."[4] See, e. g., *1432 Broadway Corp.* v. *Commissioner*, 4 T. C. 1158, affirmed, 160 F. 2d 885 (C. A. 2d); *Wetterau Grocer Co.* v. *Commissioner*,

[4] While it is true that in sustaining the Tax Court's findings as to the nature of the corporate obligations involved in the *Kelley* and *Talbot Mills* cases, this Court applied the "*Dobson*" rule (*Dobson* v. *Commissioner*, 320 U. S. 489) governing the scope of appellate review of Tax Court decisions, and that rule has since been supplanted by the "clearly erroneous" rule (Rule 52(a), Federal Rules of Civil Procedure), the *Kelley* and *Talbot* cases, nevertheless, still stand for the proposition that the question is one of ultimate fact for the Tax Court, whose decision may not be upset if supported by substantial evidence. See *Janeway* v. *Commissioner*, 147 F. 2d 602 (C. A. 2d).

179 F. 2d 158 (C. A. 8th); *Brown-Rogers-Dixson Co.* v. *Commissioner*, 122 F. 2d 347 (C. A. 4th); *Staked Plains Trust* v. *Commissioner*, 143 F. 2d 421 (C. A. 5th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C. A. 7th); 4 Mertens, *Law of Federal Income Taxation*, § 26.10c.

In the instant case, the Court of Appeals—distinguishing its prior decision in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C. A. 2d)—found that (Pet. 16) "Here * * * we are confronted with 'hybrid' securities" and that it was therefore "necessary to consider the individual provisions of the Income Notes and the history of their issuance and subsequent treatment in order to determine whether they represent an actual indebtedness or, in reality, equity capital." Applying the tests laid down in the *Kelley* and *Talbot Mills* cases, *supra*, it concluded that the record (Pet. 17-18) "clearly support[s] the Tax Court conclusion that * * * [the notes] were never evidences of indebtedness, but actually represented disguised equity capital." That conclusion is supported by substantial evidence.[5] Under the settled rule of this Court, the concurrent factual deter-

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[5] For example, as to the circumstances surrounding the issuance of the taxpayer's notes to its parent's stockholders, there was evidence, as summarized by the Court of Appeals, that the exchange of the taxpayer's capital stock and income notes for its parent's assets was merely a (Pet. 13) "first step" in the successful execution of a plan "to avoid United States income taxes assessed against New York upon profits made elsewhere," and further that (Pet. 17):

> The Notes were not issued for new capital obtained by the Greggs from outside sources, nor for borrowed money. They were issued in exchange for the assets of

minations of both courts below are final here, in the absence of clear error. *Comstock* v. *Group of Investors*, 335 U. S. 211, 214.

2. The petition alleges no direct conflict between the instant case and the decisions of this Court or of other Courts of Appeals.[6] Nor does the so-called (Pet. 10) "thin capitalization question" warrant further review of the case by this Court. Contrary to the taxpayer's assertion that the disproportionate ratio of debt to capital was (Pet. 10) "the *moving* factor in the disallowance of the interest deduction"

New York, which, like the petitioner, was a Gregg family corporation. Since the Notes were distributed to the shareholders of New York in proportion to their equity interests in that company, the relative interests in the Gregg businesses of each New York stockholder was not changed. In 1939, when the taxpayer's Notes held by Louis Gregg and his family were retired, the Panama company also retired an equal amount of its preferred stock, thus illustrating the correlation between the taxpayer's Income Notes and the equity interests in the Gregg enterprises.

As to the notes themselves, among other things, the record showed that they were unsecured, were to mature fifty years later, and were redeemable at any time; they carried no definite interest rate, only "a rate not to exceed 4%"; interest was payable out of "surplus net earnings" for the preceding year, and "only if and to the extent that the surplus net earnings and income of the Company shall suffice for such payment"; interest was noncumulative; and even if the obligation to pay arose, interest was not payable if in the judgment of the taxpayer's directors its "net quick asset position" rendered it "undesirable to make such payment." (R. 7a, 54a-56a; Pet. 14-15.)

[6] Indeed, the only suggested conflict (Pet. 9) is between the *Kelley* decision of this Court and the Second Circuit's prior decision in the *Kraft* case.

(emphasis supplied), the simple fact is, as the taxpayer concedes, that (Pet. 10) "thin capitalization was not discussed either by the Tax Court or by the Court of Appeals in the instant case," and, having in mind the articulated bases for the decision below, it cannot be said "that the *other* incidents of the transactions did not warrant the inference reached, *viz.*, that the advances were contributions of risk capital and were so intended by the parties to the transactions" (emphasis supplied). *Reed* v. *Commissioner*, decided March 15, 1957 (C. A. 2d).

The question here is substantially the same as that presented in *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), in which this Court recently denied a petition for certiorari.[7] There is no more reason for further review of this case than of that one.

CONCLUSION

The decision of the court below is correct, there are no conflicting decisions, and further review is not warranted. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APRIL, 1957.

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[7] No. 709, This Term, certiorari denied March 11, 1957.

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